IAIS

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

INSURANCE CORE PRINCIPLES, STANDARDS, GUIDANCE AND ASSESSMENT METHODOLOGY

Revised ICP 15 and ComFrame material in ICP 15 for public consultation (clean version)

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ICP 15 Investments

The supervisor establishes investment requirements for solvency purposes in order for insurers to make appropriate investments taking account of the risks they face.

Basis for establishing regulatory investment requirements

15.1 The supervisor establishes regulatory investment requirements on the investment activities of the insurer.

15.1.1 The nature of insurance business necessitates the investment in and holding of assets sufficient to cover technical provisions and capital requirements. The quality and characteristics of an insurer's asset portfolio and the interdependence between the insurer's assets and its liabilities are central to an assessment of an insurer's solvency position, and therefore, are important aspects to be addressed by the supervisor and for an insurer to manage.

15.1.2 Financial requirements alone are not sufficient to ensure solvency, and should be complemented with appropriate quantitative and/or qualitative requirements limiting/regulating investment risk. Having such requirements helps to guard against the possibility that the regulatory capital requirements do not fully cover the risks inherent in those investment activities.

15.1.3 Factors to consider in establishing regulatory investment requirements may include:

- the overall quality of risk management practices and corporate governance frameworks of insurers;
- the way in which the quality of capital resources is addressed by the supervisor, including whether or not quantitative requirements are applied to the composition of capital resources;
- the comprehensiveness and transparency of disclosure frameworks in the jurisdiction and the ability for third parties to exercise sufficient scrutiny and market discipline;
- the development of relevant investment and capital markets locally and internationally and the range of available financial instruments;
- the cost of compliance, the impact on innovation and the effect on the efficiency of industry practices; and

- the level of prudence and risk-sensitivity of the regulatory solvency requirements and the risks that they cover.

15.1.4 Additionally, the supervisor should consider requirements applied in other, non-insurance, financial sectors when establishing regulatory investment requirements for insurers. It is important that requirements across financial sectors are as consistent as possible in order to prevent groups from transferring assets between its entities to take advantage of regulatory arbitrage. Consistency of regulation between sectors may assist in maintaining a level playing field and enhancing fairness. However, such requirements should take into account the differences in risk profiles and risk management between sectors.

15.1.5 Openness and transparency of the regulatory investment requirements may help facilitate their effectiveness. The supervisor should be explicit as to the objectives of setting regulatory investment requirements. This is particularly important in order to ensure the consistency of such requirements with other building blocks of the regulatory solvency assessment of the insurer, such as the valuation of assets and liabilities, the calculation of regulatory capital requirements and the determination of available capital resources.

Rules-based and principles-based approaches

15.1.6 Regulatory investment requirements may take many forms and may influence the investment strategies of the insurer. Requirements may be rules-based, setting out specific rules or restrictions on the investment activities of the insurer, or principles-based, where there is no specific restriction on the asset strategy taken by the insurer, as long as defined principles are met.

15.1.7 Regulatory investment requirements may also be a combination of rules-based and principles-based, setting out some specific rules or restrictions and some principles with which the insurer's investment strategy should comply.

15.1.8 Rules-based requirements may be used to prohibit or limit specific classes of investment. Such rules or restrictions may either be applied directly to the investments or lead to charges to or deductions from available capital which act as a disincentive to investment in risky assets or high concentrations in particular assets, rather than as a prohibition.

15.1.9 Rules-based requirements may be relatively easy to enforce by supervisors, as there is limited scope for different interpretations of the rules.

15.1.10 One advantage of principles-based requirements is that there is more flexibility for the insurer to choose particular investments and

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therefore to follow an investment strategy that it believes is the most appropriate to its risk appetite and overall financial objectives. The insurer will be able to select and follow an investment strategy to best manage its investment risks. It may also be more difficult for the supervisor to take appropriate measures as principles-based investment requirements allow some scope for differences in interpretation.

Group perspectives

15.1.11 For insurance groups, regulatory investment requirements should specify how investments are to be aggregated. Such requirements should include appropriate mitigation of risks associated with intra-group transactions, for example, to limit contagion or reputational risk. Issues to be considered may include exposures to related counterparties and other interests over which the insurer has some influence. In stress situations there will tend to be greater restrictions on movements and realisation of investments across the group. The regulatory investment regime may, therefore require contractual evidence of the ability to access assets for solvency purposes before allowing their inclusion for group purposes.

15.1.12 The regulatory investment requirements that apply at the insurance legal entity and group levels, as well as the objectives of such requirements should be explicit. Such requirements should include issues specific to groups, such as requirements for liquidity, transferability of assets and fungibility of capital within the group.

15.1.13 In addition to meeting the qualitative and quantitative investment requirements at an insurance legal entity level, the insurance group should monitor investment risk exposures on an aggregate basis for the group as a whole.

15.1.14 Regulatory investment requirements should be set having regard to the possibility of losses from investments made by entities of an insurance group weakening another entity or the group as a whole (for example, if there is explicit or implicit support from another entity).

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Regulatory investment requirements regarding asset portfolio

15.2 The supervisor requires the insurer to invest assets so that, for its portfolio as a whole:

- **assets are sufficiently secure and are held in the appropriate location for their availability;**
- **payments to policyholders or creditors can be made as they fall due; and**
- **assets are adequately diversified.**

Group perspectives

15.2.1 The assets of an entity within an insurance group may include participations or investments in another entity within the same group. Appropriate investment requirements should apply to such investments or participations, particularly due to liquidity concerns. Relatively small holdings in another insurance group entity which does not give the investor control over the issuer may, for example, be subject to the same requirements that apply to investments in entities external to the group. On the other hand, for larger holdings which give the investor control or significant influence over the issuer, consideration should be given to aggregating the assets of the issuer with those of the investor for the purposes of applying investment requirements. This is done so that adequate security, liquidity and diversification are maintained and that the investor, using its control over the issuer, ensures the issuer's investment activities are consistent with its own investment policy.

Security

15.2.2 The insurer's investments should be sufficiently secure for the portfolio as a whole. This is essential in ensuring the obligations to policyholders can be met. Regulatory investment requirements may restrict the insurer's selection of, and/or exposure to, investments that have low security or whose security is difficult to assess reliably. There should be appropriate measures in place to recognise and mitigate aggregations of exposure across the insurer's portfolio, having particular regard to concentrations of low security assets or those whose security is difficult to assess reliably.

15.2.3 The value of an investment can be affected by the default risk of the issuer, as well as other market risks (including currency risk). Security is also affected by the safekeeping, custodianship (including the appropriate location for availability) or trusteeship of investments.

15.2.4 External credit ratings can assist the insurer in determining the credit risk of an investment. However, the insurer should be aware of the limits of using credit ratings and conduct its own due diligence to assess credit risk. The supervisor may also establish requirements on the appropriate use of credit ratings by the insurer for an independent credit analysis, which may help improve the security of investments.

15.2.5 To assess the security of its investments, it is important that the insurer is capable of assessing the nature, scale and complexity of the associated risks. This may be difficult in cases where there is a lack of transparency as to the underlying risk profile of an investment, such as indirect investments through a collective investment fund or for investments in complex financial instruments such as structured

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assets. Some markets may also suffer from a lack of transparency or clarity, applicable regulatory and legal systems and the degree of protection that they provide.

15.2.6 For assets lacking in transparency, the risk profile should be carefully analysed by the insurer. The insurer should look through to the underlying exposure of the investment as far as possible, considering the additional risks that are due to the investment structure. For example, additional legal risks may arise if investments are located outside of the insurer's operating jurisdiction(s).

15.2.7 The insurer should evaluate the security of derivative products by taking into account the underlying assets or liabilities, as well as the security of the derivative counterparty, the purpose for which the derivative is held, and the cover (such as collateral) the insurer has for derivative exposures. In some cases, derivative counterparties may improve the security by giving the insurer the right to collateral if the counterparty fails. Similarly, the security of investments may be improved by guarantees from third parties.

15.2.8 When lending securities, an insurer should consider both the counterparty risk and the risk of the securities themselves. The insurer should ensure that securities lending transactions are appropriately collateralised (with suitably frequent updating) and should recognise that lending a security does not mitigate its risks for the insurer, even if lending removes the security from the balance sheet. Care should be taken by the insurer when investing the collateral it holds to ensure it will continue to cover the lending under adverse market conditions.

Security – group perspectives

15.2.9 The supervisor should make appropriate allowance for the possibility that aggregation of exposures in an insurance group compounds security issues that may be relatively less important when considered at individual entity level. The supervisor should limit a group investing in assets that are not secure, and which otherwise could be distributed around the group to avoid investment restrictions.

CF 15.2a The group-wide supervisor requires the Head of the IAIG to establish a group-wide investment policy that sets criteria for investment quality and addresses the selection of, and exposure to, low-quality investments or investments whose security is difficult to assess.

CF 15.2a.1 The group-wide investment policy should take into account the different regulatory investment requirements of the jurisdictions in which the IAIG operates related to investments in low-quality assets.

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CF 15.2b The group-wide supervisor requires the IAIG to avoid placing undue reliance on assessments by credit rating agencies with regard to investment selection and risk management process, and to conduct its own due diligence.

CF 15.2b.1 The IAIG should not solely rely on the credit risk assessment provided by credit rating agencies. The IAIG should conduct due diligence to check the appropriateness of such credit risk assessments using various sources of information and conducting its own credit assessments on its larger or more complex exposures.

Liquidity

15.2.10 The insurer should have assets that generate sufficient cash flows to pay benefits to policyholders when due. The cash generated from investments includes disposals, maturity, and coupon or dividend payments.

15.2.11 The ability of the insurer to remain liquid may be adversely impacted for a variety of reasons. For example, the insurer:

- pledges or hypothecates its assets;
- experiences an unexpectedly large claim;
- experiences an event resulting in many claims; or
- has a derivative that needs to be serviced.

15.2.12 The ability to realise or liquidate an investment at any point in time is important. For example, where an investment is made in a closed fund, a resale is usually not possible. This would impede the security of the investment in terms of its ability to settle obligations towards policyholders. Similar considerations would need to be given for property used by the insurer which might be hard to liquidate without an operational disruption.

Liquidity – group perspectives

15.2.13 The insurers and home and host supervisors should consider the nature of the potential legal and practical impediments to cross-border transfer of assets as well as any potential effect those impediments might have, particularly in a resolution.

15.2.14 Group issues are relevant when managing liquidity risk, both in terms of the availability of additional liquidity and the possible need to provide liquidity support to other parts of the group.

15.2.15 Entities within a group frequently engage in intra-group transactions (e.g. swaps, inter-company loans) in order to offset risks that exist in

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different parts of the group or to have more mature businesses support growing businesses within the group. Such transactions should be done using appropriate transfer pricing based on current market conditions so that there is appropriate recognition of the impact of these transactions for each of the entities involved and the group as a whole.

15.2.16 Liquidity of assets and fungibility of capital are especially important if the group relies on diversification between entities without each entity being fully capitalised on a stand-alone basis (where allowed by the supervisor). The insurers should consider their liquidity needs, transferability of assets and fungibility of their capital in a stressed environment when determining the minimum criteria for liquidity of their investment portfolio.

CF 15.2c The group-wide supervisor requires the Head of the IAIG to consider the effect of any potential legal and practical impediments to the IAIG's ability to transfer capital and assets on a cross-border basis.

CF 15.2c.1 The IAIG should document any specific legislative restrictions that apply to the transfer of capital and assets from one jurisdiction to another, and what, if any, additional restrictions apply in the case of the resolution of an entity. The IAIG should also have documented procedures on actions that affect the cross-border transfer of capital and assets in normal and stressed times.

CF 15.2d The group-wide supervisor requires the Head of the IAIG to set minimum criteria for the liquidity and location of its investment portfolio in the group-wide investment policy so that the IAIG can make payments to policyholders or creditors when and where they fall due.

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Diversification

15.2.17 Diversification and pooling of risks is central to the functioning of insurance business. To mitigate the risk of adverse financial events, it is important that the insurer's overall investment portfolio is adequately diversified and that its asset and counterparty exposures are kept to prudent levels.

15.2.18 There is a distinction between diversification within a risk category and diversification between risk categories. Diversification within a risk category occurs where risks of the same type are pooled (e.g. shares relating to different companies). Diversification between risk categories is achieved through pooling different types of risk. For example, where the insurer combines two asset portfolios whose performances are not fully correlated, the exposure to the aggregated risks will generally be lower than the sum of the exposures to the risks in the individual portfolios.

15.2.19 With respect to its investment portfolio, the insurer should ensure that it is diversified within and between risk categories, taking into account the nature of the liabilities. Diversification between investment risk categories could, for example, be achieved through spreading the investments across different classes of assets and different markets. For diversification within a risk category, the investments are sufficiently uncorrelated so that – through pooling of individual assets – there is a sufficient degree of diversification of the portfolio as a whole.

15.2.20 To ensure that its investment portfolio is adequately diversified, the insurer should avoid excessive reliance on any specific asset type, issuer, counterparty, group, or market and, in general, any excessive concentration or accumulation of risk in the portfolio as a whole. For example, the insurer may consider its asset concentration by type of investment product, by geographical dispersion, or by credit rating. The insurer should consider its aggregate exposure to related entities and different types of exposure to the same entity/group (e.g. equity investment in a reinsurer which is also providing its reinsurance cover).

Diversification – group perspectives

15.2.21 Having risk management processes to monitor investments on a group-wide basis is more likely to make Senior Management aware of issues (e.g. asset concentrations) that could be overlooked if only the individual legal entities are monitored. Groups that are unaware of their global exposures could face an inappropriate level of exposure to certain investments, which may create financial difficulties within the group if the value or liquidity of these investments decreases.

CF 15.2e The group-wide supervisor requires the Head of the IAIG to set limits or other requirements in the group-wide investment policy so that assets are properly diversified and asset concentration risk is mitigated.

CF 15.2e.1 The IAIG should avoid excessive concentrations in any particular:

- type of asset;
- issuer/counterparty or related entities of an issuer/ counterparty;
- financial market;
- industry; or
- geographic area.

CF 15.2f The group-wide supervisor requires the Head of the IAIG to monitor investments on a group-wide basis to identify levels of exposure to certain investments that are inappropriate according to the group-wide investment policy.

CF 15.2f.1 Group-wide exposures which exceed limits or any other instances of non-compliance should be reported periodically to the Head of IAIG. Reports to the Head of IAIG should also include exposures that, even if within limits, could create financial difficulties within the IAIG if the value or liquidity of the investments decreases.

Regulatory investment requirements relating to the nature of the liabilities

15.3 The supervisor requires the insurer to invest in a manner that is appropriate to the nature and duration of its liabilities.

15.3.1 Assets that are held to cover policyholder liabilities and those covering regulatory capital requirements should be invested in a manner which is appropriate to the nature of the liabilities, as the insurer needs to use the proceeds of its investments to make payments to policyholders and other creditors when due. The insurer's investment strategies should take into account the extent to which the cash flows from investments match the liability cash flows in terms of timing, amount and currency, and how this changes in varying conditions. In this context, the insurer should specifically consider investment guarantees and embedded options that are contained in its insurance policies.

15.3.2 Insurers are not necessarily required to employ an investment strategy which matches the assets and the liabilities as closely as possible. However, to the extent that assets and liabilities are not well matched, movements in financial variables (e.g. interest rates, market values and exchange rates) may affect the value of the assets and the liabilities differently and result in an adverse economic impact for the insurer.

15.3.3 As liability cash flows are often uncertain, or there are not always assets with appropriate cash flow characteristics, the insurer is usually not able to adopt a completely matched position. Additionally, the insurer may wish to adopt a mismatched position deliberately in an attempt to optimise the return on its business. In such circumstances, the supervisor may require the insurer to hold additional technical provisions and/or capital to cover the mismatching risk. The regulatory investment requirements may also constrain an insurer's ability to mismatch its assets and liabilities as the extent of mismatching should not expose policyholders to risks that cannot be effectively managed by the insurer.

15.3.4 Nevertheless, close matching of assets and liabilities is often possible and should be considered as a potential requirement in the case of unit-linked or universal life policies where there is a direct link between policyholder benefits and investment funds or indices. It may not be possible for the mismatching risk to be covered effectively by capital. Where the supervisor requires assets to be closely matched to such liabilities, other restrictions on investments may be appropriate to contain the investment fund risk being borne directly by policyholders.

15.3.5 The insurer should manage conflicts of interest (e.g. between the insurer's corporate objectives and disclosed insurance policy objectives) to ensure assets are invested appropriately. For with-profits liabilities, an insurer should hold an appropriate mix of assets to meet policyholders' reasonable expectations.

Group Perspectives

15.3.6 Investments that back liabilities including those covering regulatory capital requirements within one of a group's insurance legal entities should be tailored to the characteristics of the liabilities and the needs of the insurance legal entity and not subject to undue influence from the wider objectives of the group.

Regulatory investment requirements regarding risk assessability

15.4 The supervisor requires the insurer to invest only in assets where it can properly assess and manage the risks.

15.4.1 The insurer should ensure that its investments, including those in collective investment funds, are sufficiently transparent and should limit its investments to those where the associated asset risks can be properly managed by the insurer.

15.4.2 The insurer should understand sufficiently the risks involved before any investments are undertaken in order to assess how material the risk from a proposed investment is to an insurer. Assessment of risks should take into account the maximum possible loss, including losses that may occur in situations where assets become liabilities for the insurer.

15.4.3 Where the insurer is able to look through the structure of the investments to the underlying assets, the insurer should consider the risk characteristics of the underlying assets and how this affects the risk characteristics of the investments itself. However, where such a look through is not possible, appropriate techniques should be developed to assess the risks associated with the investment (e.g. by assessing the investment manager of an investment fund).

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15.4.4 Investments that are not traded on a regulated financial market should be kept to prudent levels, as the assessment of their risks may be subjective. This is particularly relevant where standardised approaches to determining regulatory capital requirements are used, since such approaches will often be designed to be not unduly complex and thus feasible in practice for all insurers. Moreover, by its very nature a standardised approach may not be able to fully and appropriately reflect the risk profile of the investment portfolio of each individual insurer.

15.4.5 The insurer should have access to the requisite knowledge and skills needed to assess and manage the risks of its investments. When using external investment advisors/managers, the insurer is responsible for determining that those parties are knowledgeable and have the requisite skills to manage the insurer's investments

Group Perspectives

15.4.6 Investments held by entities within a group are sometimes managed centrally by an investment management function, with the entities relying on its expertise. In such arrangements, the investment management function should have the requisite knowledge and skills to assess and manage the risks of these investments and manages the investments with due regard to the needs of individual entities in addition to the group as a whole.

CF 15.4a The group-wide supervisor requires the Head of the IAIG to establish limits on intra-group investments in the group-wide investment policy.

CF 15.4a.1 Limits on intra-group investments should consider, in particular:

- their lack of liquidity;
- contagion or reputational risk;
- valuation uncertainty; and
- potential impact on capital resources.

The fact that intragroup investments might be subject to supervisory approval in certain jurisdictions does not remove the requirement for the IAIG to set its own limits.

Regulatory investment requirements relating to specific financial instruments

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15.5 The supervisor establishes quantitative and qualitative requirements, where appropriate, on:

- **the use of more complex and less transparent classes of assets; and**
- **investments in markets or instruments that are subject to less governance or regulation.**

15.5.1 Complex investments may have a higher risk of large, sudden and/or unexpected losses. Similarly, there are some assets in which investment is permitted by the regulatory investment regime (because the risk is generally sufficiently assessable), but are less transparent compared to other investments. Other assets could be less well governed in terms of the systems and controls in place for managing them or the market regulation that applies to them. Such assets may present operational risks that may arise in adverse conditions which are difficult to assess reliably. In terms of market regulation, investments in an unregulated market or a market that is subject to less regulation (such as a professional securities market) need to be given special consideration.

15.5.2 The supervisor should therefore establish quantitative and qualitative requirements or restrictions on such investments. For example, regulatory investment requirements may include the pre-approval of an insurer's derivative use plan, whereby the insurer has to describe its controls over and testing of the derivative investment process before it is used in a live environment.

15.5.3 The investments described below are examples of investments that may necessitate quantitative and qualitative requirements; however, this is not an exhaustive list and regulatory investment requirements should be flexible and/or sufficiently broad to take account of the changing environment. The solvency position and the sophistication of an insurer should also be considered. The amount of available capital an insurer has could provide additional flexibility to the supervisor in particular cases.

Off-balance sheet structures

15.5.4 Special Purpose Entities (SPEs) are generally set up for a specific purpose to meet specific payments to investors who have accepted the risk profile based on the cash flows underlying the SPE. The investment strategy for an SPE may need to be more restrictive than the strategy for the insurer.

15.5.5 The investment strategy adopted by the off-balance sheet structure may have an impact on the ability of the insurer to make payments to the policyholders, especially if the structure is in a stressed position.

Investments in structured credit products

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15.5.6 An insurer may invest in securities or other financial instruments which have been packaged by an SPE and which may originate from other financial institutions (including banks or other insurers). Examples of such instruments are asset backed securities (ABS), credit linked notes (CLN) or insurance linked securities (ILS). In these cases, it may be very difficult for the insurer to assess the risk inherent in the investment, and in particular the risk profile of the underlying reference instruments, which in some cases may be of particularly poor quality (e.g. sub-prime mortgages). Where the originator is another insurer, the investment may also carry insurance related risks (such as non-life catastrophe risks in the case of a non-life catastrophe bond securitisation) which may not be transparent to the insurer or else difficult to assess.

15.5.7 If the supervisor is concerned that the insurer is exposed to an undue level of risk in such cases, it may consider establishing qualitative or quantitative requirements which may relate directly to the insurer investing in such assets, or which may relate to the originator of the packaged instrument.

15.5.8 In establishing such requirements, the supervisor may recognise that some structured credit products are higher risk than others and consider, for example:

- the treatment of such investment in other financial sectors;
- the extent to which the originator has retained an interest in a proportion of the risk being distributed to the market;
- the definition and soundness of criteria applied by the originator in extending the original credit and in diversifying its credit portfolio;
- the transparency of the underlying instruments; and
- the procedures the insurer has in place to monitor exposures to securitisations, including consideration of securitisation tranches, and reporting them to the insurer's Board and Senior Management and supervisor.

15.5.9 Restrictions or prohibitions may be applied to investments in structured products where appropriate conditions are not satisfied.

Use of derivatives and similar commitments

15.5.10 An insurer choosing to engage in derivative activities should clearly define its objectives, ensuring that these are consistent with any supervisory requirements.

15.5.11 When used appropriately, derivatives may be useful tools in the management of portfolio risk of insurers and in efficient portfolio management. In monitoring the activities of insurers involved in

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derivatives, the supervisor should satisfy itself that the insurer has the ability to recognise, measure and prudently manage the risks associated with their use. The supervisor should obtain sufficient information on the insurer's policies and procedures on the use of derivatives and may request information on the purpose for which particular derivatives are to be used and the rationale for undertaking particular transactions.

15.5.12 Given the nature of insurance operations, derivatives should preferably be used as a risk management mechanism rather than for speculation. The supervisor may restrict the use of derivatives (particularly derivatives that involve the possibility of unlimited loss) to the reduction of investment risk or efficient portfolio management. This means that where derivatives are used, it is for the purpose of reducing risk and costs or generating additional capital or income with an acceptable level of risk. Restrictions may also be applied to require the suitability of derivative counterparties, the derivative collateral, the tradability of the derivative and, in the case of over-the-counter derivatives, the ability to value and to close out the position when needed. Derivatives should be considered in the context of a prudent overall asset/liability management strategy.

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